

# Learning the instrument

International Tax

Large Corporate



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*Alison Lobb and Lisa Shipley* examine the 'multilateral instrument' that could modify bilateral tax treaties efficiently and swiftly

## Key Points

### What is the issue?

The G20/OECD have published the multilateral instrument for countries to consider before signing later this year. It covers BEPS 'minimum standards' on treaty abuse and dispute resolution, along with other BEPS measures.

### What does it mean to me?

The OECD estimates that more than 2,000 treaties could be amended. It is expected that the earliest changes could take effect in 2018

## What can I take away?

There is flexibility in how some of the treaty changes agreed under BEPS (apart from the 'minimum standards') are implemented. The UK government has published its proposed approach.

The G20/OECD's Base Erosion and Profit Shifting ('BEPS') project recognised at the outset that changes would be required to tax treaties to implement some of the measures to modernise the international tax system. Bilateral renegotiation of 3,000 or so existing tax treaties would take years to complete and therefore an important BEPS action would be to develop a 'multilateral instrument' that could modify bilateral tax treaties efficiently and swiftly.

The multilateral instrument is required to reflect the treaty changes agreed under BEPS, based on the final papers published in October 2015 (and some later work). 103 countries and jurisdictions participated in its development (along with seven international bodies). More than 50 are not members of the OECD or G20, reflecting the wide reach of the BEPS 'Inclusive Framework'. For this reason, the multilateral instrument needs to balance flexibility with limiting complexity to enable the widest possible range of countries to modify their tax treaties.

The *Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting* ('the Convention' or 'the multilateral instrument') was published on 24 November 2016, along with an accompanying *Explanatory Statement*.

The multilateral instrument covers two of the four 'minimum standards' agreed as the outcome of the BEPS project, along with other BEPS measures. The minimum standards included are those that relate to treaty matters, i.e. the prevention of treaty abuse and improved dispute resolution through mutual agreement procedures. The Convention will be open for signature by any country but it will require commitment to the minimum standards. Countries can decide whether, and to what extent, to implement clauses that do not relate to minimum standards. This flexibility is achieved through notification of any option selected and opting out of clauses by filing 'technical reservations'.

A specific treaty will be a 'covered tax agreement' and subject to the Convention only if both parties ratify and include the treaty for modification. There is no

obligation for a jurisdiction to include all existing double tax treaties and bilateral negotiations can be pursued instead.

For covered tax agreements, the multilateral instrument will in effect override the terms of the existing double tax treaty.

In general, any reservations or choices made by a country will apply to all its covered tax agreements, but can be restricted to a subset of treaties based on objective criteria.

The OECD estimates that more than 2,000 treaties could be amended if all 103 jurisdictions ratify the convention.

## **Areas covered by the multilateral instrument**

### **Treaty abuse**

This is a minimum standard to address concerns that treaties could be used to obtain treaty benefits in unintended circumstances. Three approaches are permitted:

1. Principal purposes test, i.e. treaty benefits will not be granted where one of the principal purposes of the arrangement is to obtain a treaty benefit not intended by the treaty partners;
2. Simplified limitation on benefits rules, supplemented with a principal purposes test;
3. Limitation on benefits rules (supplemented with anti-conduit rules) – No text is included in the Convention and countries adopting this approach (currently the US and Japan) must confirm that the minimum standard is met.

The UK government proposes to adopt the principal purposes test. Although it would be permitted, the UK will not accept either the bilateral or asymmetrical application of the simplified limitation on benefit rules in cases where a treaty partner adopts option (ii).

The Convention also provides a new test for corporate residence, where a company is resident for tax purposes in both treaty countries. The new test will provide that residence should be determined by the treaty partners and, failing determination, treaty benefits will not be granted. The UK will adopt this. Groups will need to

identify any subsidiaries incorporated in one country and centrally managed and controlled in another, and obtain competent authority agreement to determine residence.

The Convention also includes minimum standard changes to the preambles of treaties, together with optional provisions on: minimum shareholding periods to apply reduced rates on dividends; non-resident capital gains on shares taxable if an immovable property threshold is met. The UK will not adopt these options, considering that the principal purposes test will apply.

## **Permanent establishment**

The BEPS recommendations lower the threshold at which a taxable presence arises through:

- broadening the scope of dependent agent permanent establishments to cases where an agent ‘habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the [non-resident] enterprise’;
- narrowing exemptions for fixed place of business permanent establishments by making the exemptions subject to the activities being preparatory or auxiliary supplemented by an anti-fragmentation rule where a group carries out certain other activities in country; and
- countering avoidance where long-duration construction or installation contracts are split into a series of shorter contracts.

The permanent establishment changes are not part of a minimum standard and the UK government has indicated that it will adopt the anti-fragmentation rule, but none of the other changes. It will also not adopt an anti-abuse rule for permanent establishments situated in third countries.

## **Improving dispute resolution**

All covered tax agreements will include mutual agreement procedures as a minimum standard. The competent authorities should endeavour to agree between themselves how double tax agreements should apply in qualifying cases, and implement any agreement.

An additional amendment, not itself part of the minimum standard, is available to include the acceptance of corresponding adjustments in relation to transfer pricing (i.e. to allow a deduction where the treaty country has imposed an upward transfer pricing adjustment).

The UK government has indicated that it will adopt the provisions in full.

## **Hybrid mismatches and other provisions**

Although the majority of the BEPS recommendations require changes to domestic law, optional changes to the tax treaty treatment of transparent entities, and the application of exemption and credit methods of double tax relief are included. The UK will adopt the former change. It will also adopt the 'savings' clause, allowing a country to tax its own residents, irrespective of treaty provisions.

## **Mandatory binding arbitration**

27 countries, including the UK, formed a sub-group to develop new optional provisions on mandatory binding arbitration to provide certainty that double taxation will be eliminated. Countries are free to determine bilaterally the scope of eligible cases. Businesses will generally be able to request arbitration where a case has been subject to mutual agreement procedures for two years without resolution.

Two different approaches are available:

- 'final offer' – each tax authority presents their proposed solution and arbitrators choose between the two solutions presented;
- 'independent opinion' – arbitrators decide the outcome and provide a written decision based on analysis of the information provided.

In line with current treaty negotiation practice, the UK government intends to adopt 'final offer' mandatory binding arbitration and will impose confidentiality obligations. It will however accept 'independent opinion' arbitration if that is chosen by the treaty partner. It is interesting and positive that the working group comprised 27 countries, seven more than was indicated in October 2015 when the final BEPS package was published.

## **Next steps**

Countries must decide which tax treaties they wish to update through the Convention, and which options and reservations they wish to make.

The first signing ceremony in Paris is planned for 5 June 2017 and a significant number of countries are expected to attend. Countries will need to ratify the Convention in line with their domestic requirements, and as usual the timescale for this process will vary by country. The Convention will be finalised three months after the date of ratification by the fifth country, and enter into force for those first five jurisdictions at the start of the subsequent calendar month.

## **Identifying changes to a specific tax treaty**

The UK and Australian governments have published their proposed reservations and options (but not yet lists of covered treaties) for public consideration.

Information on covered treaties, reservations and options selected by a country will be made available when it signs the Convention. The OECD will act as a depositary and will publish this information, but the effect on a particular treaty will only be determined once information has been provided by both treaty countries.

The Convention does not function in the same way as an 'amending protocol' to an existing bilateral treaty and no direct changes will be made to the underlying treaty text. Instead, the Convention will be applied alongside the existing treaty. Although there is no requirement to do so, the UK government has committed to publishing consolidated versions of treaties, and where possible will agree these with treaty partners.

## **Application date for changes**

Start dates differ between clauses and are prospective (although cases could be eligible for dispute resolution where the dispute relates to an earlier period). The inclusion of a three-month period after ratification and before the Convention enters into force is important to provide businesses with time to apply the new rules.

Whilst dates will be determined by countries' ratifications, it seems possible that the first treaty changes made by the Convention may have effect from 1 January 2018.